SENATE TAXATION
EXHIBIT NO. 2
DATE 3.19.09
BILL NO. SB504

Mackinac Center for Public Policy

Posted: Feb. 1, 1994

The Sales Tax vs. the Income Tax

While many studies have documented the detrimental effects on economic growth of state and local taxes and of the personal income tax, a 1982 study by Richard Vedder was one of the first to directly compare the effects of the personal income tax with those of the sales tax.**[11]** Vedder ranked the states by real growth in per capita personal income from 1970 to 1980. The 16 states with the fastest income growth were the "high-growth" states, while the 16 with the slowest income growth were the "low-growth" states. Vedder found that the 1980 per capita state and local tax burden in the low-growth states was more than 25 percent higher than in the high-growth states.

Looking at the income and sales taxes separately, however, provided a very different picture. The per capita state and local income tax burden in the low-growth states was 125 percent higher than in the high-growth states. In contrast, the sales tax burden in the low-growth states was actually a bit lower than in the high-growth states. This supports what economic theory tells us about the relative effects on economic growth of the income tax and the sales tax. Vedder surmises, "it would appear that from the standpoint of maximizing the rate of economic growth, the optimal state and local fiscal policy would be one in which the overall tax burden is comparatively low, coupling high sales taxes with low income and property taxes."**[12]**

A 1992 Cato Institute study included a similar exercise, examining the nation's 80 largest cities.**[13]** It found that of the 13 cities that experienced the fastest real per capita income growth, only one imposed an income tax, while over one-third of the low-growth cities had an income tax. While the low-growth cities depended more heavily on the income tax, the high-growth cities were more dependent on the sales tax. The average per capita sales tax burden in the high-growth cities of $155 was more than *double* the $72 per capita sales tax burden in the low-growth cities. This further supports the assertion that high income tax burdens tend to inhibit economic growth while high sales tax burdens, relatively speaking, do not.

A 1993 study by Stephen Moore provided further support for the theory that income tax increases do inordinate harm to economic growth.**[14]** Moore summed the enacted revenue increases**[15]** in each state in fiscal years 1990 through 1993 as a percentage of 1990 personal income, and examined economic growth figures over that time. He found that the top ten tax-increasing states experienced a net gain of only 3,000 jobs, an increase in the unemployment rate of 2.2 percentage points, and a $484 real decline in personal income per family of four.

The performance of the top ten *income* tax-increasing states was even worse--a loss of 182,000 jobs, a 2.3 percentage point increase in unemployment, and a $613 real decline in personal income per family. In contrast, unpublished research for the Cato Institute shows that the performance of the top ten *sales* tax-increasing states over that same period was markedly better--a net gain of 408,000 jobs, only a modest 0.4 percentage point rise in unemployment, and a $1,568 real increase in personal income per family.**[16]**

This text is part of the larger publication:
Sales vs. Income Taxes: The Verdict of Economists

Return to **standard version**.

Copyright © 1994 Mackinac Center for Public Policy

Introduction

On March 15, 1994, Michigan voters will render a decision on an important question relating to public school finance-one of the most complex propositions ever placed on the ballot here. "Proposal A" offers a mix of taxes to replace property taxes for schools eliminated by the legislature and Governor Engler last summer, as does a "back-up" or "statutory" plan that will automatically take effect if Proposal A fails.

The elements of these two plans are numerous and complicated. Important constitutional questions are involved. The ability of local and state governments to raise taxes from the levels each plan would initially establish ought to be important to taxpayers as they consider their options. And what the voters are buying for their money under each plan is not to be ignored either. These are but a few of the factors that carry weight in the March 15 decision, but they are not the subjects of this paper.

The focus of author Dean Stansel's analysis is the question, "Which impacts a state's economy with the least negative effects, the sales tax or the income tax?" This question, though it is one of many that voters must consider, is nonetheless central to the choice between Proposal A and its statutory alternative. Proposal A would raise the sales tax from 4% to 6% and cut the flat-rate personal income tax rate from 4.6% to 4.4%. The statutory plan would leave the sales tax unchanged and raise the income tax rate to 6%.

The U.S. Advisory Commission on Intergovernmental Relations (ACIR) calculates relative "tax capacity" and "tax effort" for every state. Tax capacity is an estimate of the amount of revenue a state would collect if it utilized a "representative" tax system comprised of national average tax rates applied to commonly used tax bases. A state's tax effort is the ratio of its actual revenues to its estimated capacity. According to ACIR data for 1991, Michigan's sales tax capacity ranked 24th, at 3 % below the national average, while the state's sales tax effort ranked 43rd, at a substantial 31% below the national average. Michigan's personal income tax capacity, meanwhile, ranked 18th, at just 1% below the national average, while its personal income tax effort ranked 27th, at 4% above the national average. At least in relation to the other states, it would appear that Michigan has less "room" to raise its income tax than it does to raise its sales tax.

Dean Stansel draws a clear conclusion on the issue of sales vs. income taxes and their relative economic effects. His finding should be helpful to voters as they decide how they will vote on March 15, but it should not by itself make the decision for them.

Finally, school finance is inevitably tied up with what it is we are financing. The Mackinac Center for Public Policy has made it plain in other forums that neither Proposal A nor the statutory plan buys us the sort of fundamental reform our educational system desperately needs. Irrespective of the March 15 outcome, the Governor and the legislature should work for those initiatives that will infuse competition and parental choice into the system, contain excessive costs through more contracting with the private sector, liberate teachers from stifling mandates and bureaucracy, and expand charter schools.

----Lawrence W. Reed, President, The Mackinac Center for Public Policy

For years, the effect of state and local taxes on economic growth has been a topic of much debate. Until the mid-1970s the conventional wisdom was that state and local taxes did not substantially affect economic decision-making. More recently, however, there is a growing body of empirical research which suggests otherwise. Many economists now agree that high and rising state and local tax burdens can significantly inhibit economic growth, and further, that some taxes can be far more harmful than others.

Economic theory speaks clearly on how the various kinds of taxes can affect economic growth. *More specifically, there is little theoretical disagreement with the assertion that consumption taxes are less harmful to economic growth than are income taxes.*

What Theory Tells Us

It is widely held that income taxes have a negative effect on saving. By taxing both labor income (wages and salaries) and investment income (interest on savings, dividends, etc.) personal income taxes subject savers to double taxation, forcing them to pay taxes first on their salary and then again on the investment income earned by the portion of their salary which they save. This double taxation makes saving less financially rewarding.

Acting as rational economic agents, individuals respond to the incentives of income taxes by saving less of their income than they would in the absence of an income tax. This artificially low level of saving causes the capital stock to be smaller than it otherwise would be. In the long run, this leads to slower productivity growth, which causes living standards to rise less rapidly and reduces corporate profitability, thus making it more difficult for firms to expand and hire new workers. In sum, income taxes place a major burden on economic growth.

Consumption taxes, on the other hand, do not directly punish saving. Since a given level of income can only be consumed once, using consumption as the tax base avoids the problem of double taxation present under an income tax. As a result, consumption taxes do not discourage saving.**[1]** Therefore, the growth-inhibiting effects of the income tax are not present with a sales tax. Given the choice between a higher income tax and a higher sales tax, the sales tax wins hands down with respect to minimizing the harm to economic growth.

A Word on Regressivity

One final matter of economic theory often raised in discussions of consumption taxes is their purported regressivity. It is an almost universally-accepted notion that consumption taxes are regressive--i.e., that they consume proportionally more of the income of the poor than of the rich. However, this assertion stems from faulty analysis. Consumption taxes are thought to be regressive because most economists measure regressivity by examining the portion of *annual* earnings which go toward the tax.

Using annual earnings as the basis for defining who is poor is misleading because it includes individuals who would not typically be thought of as poor. In fact, by this definition, virtually everyone qualifies as poor at some time during their life. That is because annual earnings are low for most individuals--"rich" or "poor"--during two specific phases of their lives: early-career and retirement.

It is widely believed that individuals "smooth" their level of consumption (relative to the fluctuations in their income) over the span of their lifetime. Therefore, while in these two "poor" stages of their lives, most individuals spend more than they earn (either because they expect their future income to rise appreciably, as in early-career, or because they have accumulated sufficient savings over their working years, as in retirement). As a result, while in these two "low-eamings" stages of life, virtually all individuals will indeed pay a proportionately larger share of their income in sales taxes than do those in the "higher-earnings" phase of life.

However, since most of these temporarily "poor" people will either someday enter or have previously been in the more lengthy middle-age, "higher-earnings" stage of their lives, indiscriminately including all of them in a group called "the poor" is misleading, and substantially overstates the regressivity of consumption taxes.

A more useful way of measuring the regressivity of a consumption tax is to examine the portion of *lifetime*--rather than annual--earnings which go towards such taxes. A recent National Bureau of Economic Research working paper by Gilbert Metcalf did just that. By looking at income over individuals' lifetimes rather than just during one year, Metcalf found that "rich people actually pay proportionally 1-1/2 times more of their income in sales tax than do the poor."**[3]** Though Metcalf is not the first to note the serious flaw in using annual rather than lifetime earnings,**[4]** the enduring belief that consumption taxes are regressive lives on.

In a 1993 study for The Mackinac Center for Public Policy, analyst Patrick L. Anderson addressed the regressivity issue, noting that despite frequent claims to the contrary, Michigan's sales tax is actually slightly progressive because "the proportional burden increases as income increases."**[5]** The lifetime earnings factor cited above is one reason. Another reason is this: the sales tax (as well as the state's use tax) excludes food, prescription drugs, and most services, including rent. For many lower income taxpayers, food, drugs and rent comprise a very high proportion of their household spending. (As a statewide total, noted Anderson, sales and use tax revenue compared with personal income in the state indicates that about 45% of income is spent on sales-or use-taxable items.)

Empirical Evidence

Over the years, there has been substantial empirical research, testing economic theories of the effects of taxation on economic growth. And, though earlier work said otherwise, there is now a growing body of empirical research that suggests that high and rising tax burdens--especially taxes on personal income--do significantly inhibit state economic growth.**[6]** Unfortunately, few of these studies have examined the relative effect of sales taxes on economic growth. (This paucity of research likely stems, in part, from the breadth of theoretical agreement as to what those relative effects are.)

One of the earliest studies that found the personal income tax to be a drag on economic growth was done in 1981 by Professor Richard Vedder of Ohio University.**[7]** Vedder compared the tax policies in the 16 states that saw the fastest growth in income from 1970 to 1979 with those in the states that saw the slowest growth in income. He found that the low-growth states had 1970 state and local personal income tax burdens (expressed as a share of personal income) that were more than *double* the income tax burdens in the high-growth states. Furthermore, from 1970 to 1979 the income tax burden went up one and two-third times as much in the low-growth states as in the high-growth states. Vedder surmised, "Income taxes levied on individuals and corporations are particularly detrimental to growth, more so than consumption-based taxes or user charges that do not reduce the incentives to work or form capital."**[8]**

A 1987 study by the Iowa Tax Education Foundation (ITEF) attempted to determine why Iowans were fleeing the state in record numbers. (It was widely reported that some 80,000 residents left the state between 1980 and 1987.) By surveying hundreds of former Iowans, ITEF found that the state's inordinately high personal income tax rates (their 1980 top marginal rate of 13% remained in place until 1988 when it was lowered to 10%) were a major factor in the decision to leave the state.**[9]**

A 1992 study by Thomas Dye examined the growth rates of personal income in the eight most recent states to adopt a personal income tax (excluding Connecticut which did so in 1991). Dye found that six of the eight states suffered a significant slowdown in the rate of growth of personal income after enactment of the tax. (Additionally, six experienced a sharp increase in state government spending after enactment.)**[10]**

Connecticut: Does the Composition of Taxes Really Matter?

Finally, recent fiscal events in the state of Connecticut have provided a real-world test of the theory that personal income taxes are more harmful to economic growth than sales taxes. In 1991, state leaders enacted a tax reform package that was the exact opposite of what economic theory and a growing body of empirical research tells us is required to avoid economic decline. Connecticut imposed a new state personal income tax and made a substantial *reduction* in the state sales tax.**[17]**

By the tax growth measure in Moore's (1993) study, that tax package helped to rank Connecticut as both the top tax-increasing state *and* the top *income* tax-increasing state in the nation. Connecticut's dismal economic performance since the 1991 tax change should come as no surprise. The state has led the nation in job loss with a decline of 5.3 percent (84,000 lost jobs),**[18]** and the state population has fallen by 13,000, also the largest decline in the nation.**[19]**

Conclusion

Economic theory, a growing body of empirical research, and real world evidence from states such as Connecticut all point to the same conclusions. High and rising state and local tax burdens can have a severe detrimental effect on economic growth. Therefore, restraining the overall level of state and local taxes is of prime importance in maintaining a thriving state and local economy. However, the specific composition of that tax burden can have a major influence as well. Theory as well as the preponderance of empirical evidence suggest strongly that sales taxes have less adverse impact on a state's economy than do income taxes.

It naturally follows, then, that state and local economic prosperity in the 1990s can be enhanced by focusing on three factors: 1) strict overall tax restraint, 2) maintaining tax burdens that are competitive with geographical neighbors, and 3) reducing the burden of anti-growth state and local income taxes.

About the Author

Dean Stansel is a fiscal policy researcher at the Cato Institute in Washington, D.C. and an adjunct scholar with The Mackinac Center for Public Policy. Together with Stephen Moore, he coauthored a November 1993 report for The Mackinac Center entitled, "A Prosperity Agenda for Michigan Cities."

Endnotes

1. However, nor do they encourage it. Taxes on consumption are neutral between consumption and saving. For a more detailed discussion of this matter see Chapter II in: Schuyler, Michael A., Consumption Taxes: Promises and Problems, Institute for Research on the Economics of Taxation, Fiscal Issues series, No. 4, 1984.
2. Tiebout, Charles, "A Pure Theory of Local Expenditures," Journal of Political Economy, Vol. 64, October 1956, pp. 416-24.
3. As reported in *Washington Post*, February 6, 1994, p. C5.
4. See Schuyler, p. 18; and James Davies, Francis St. Hilaire, and John Whalley, "Some Calculations of Lifetime Tax Incidence," American Economic Review, September 1984, pp. 633-49.
5. Anderson, Patrick L., "Proposal A: An Analysis of the June 2, 1993 Statewide Ballot Question," Mackinac Center for Public Policy, May 1993, p. 15.
6. For a brief summary of this more recent body of research, see: Vedder, Richard, "Tiebout, Taxes, and Economic Growth," Cato Journal, Vol. 10, No. 1 (Spring/Summer 1990), pp. 101-103.
7. Vedder, Richard, "State and Local Economic Development Strategy: A Supply Side Perspective," Joint Economic Committee of the U.S. Congress, October 1981.
8. Ibid., p. 340.
9. Iowa Tax Education Foundation, "The Iowa Exodus: Why Are People Leaving This State?" 1987.
10. Dye, Thomas, "State Income Taxation: Fueling Government, Stalling the Economy," in Tex Lezar, ed., Making Government Work: A Conservative Agenda for the States, Texas Public Policy Foundation, 1992, pp. 363-81.
11. Vedder, Richard, "Rich States, Poor States: How High Taxes Inhibit Growth," Journal of Contemporary Studies, Fall 1982, pp. 19-32.
12. Ibid., p. 22.
13. Moore, Stephen, and Dean Stansel, "The Myth of America's Underfunded Cities," Cato Institute Policy Analysis No. 188, February 1993, pp. 25-26.
14. Moore, Stephen, "Taxing Lessons from the States: Why Much of America Is Still in a Recession," Joint Economic Committee of the U.S. Congress, October 1993.
15. "Enacted revenue increases" refers to increases in revenue that stem directly from an explicit change in the state tax code.
16. Stansel, Dean, unpublished research, Cato Institute, 1994. (Available from the author upon request.)
17. "The state sales tax was cut from 8 percent to 6 percent. However, the base was also broadened to include various services, and several exemptions were weakened.
18. "Despite Well-publicized Layoffs, Job Growth Has Outpaced Losses," *Washington Times*, October 18, 1993, p. A14.
19. U.S. Bureau of the Census.